No. 2560

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

COLUMBIA DIGGER COMPANY,
a corporation,
Plaintiff in Error,

vs.

M. R. SPARKS and C. A. BLUROCK,
Defendants in Error.

PETITION OF PLAINTIFF IN ERROR FOR A REHEARING.

R. R. GILTNER,
RUSSELL E. SEWALL,
GUY C. H. CORLISS,
Attorneys for Plaintiff in Error and Petitioner.

Filed this_____day of September, 1915

FRANK D. MONCKTON, Clerk

By_____Deputy Clerk.

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To the Honorable William B. Gilbert, Presiding Judge, and the Associate Judges of the United States Circuit Court of Appeals, for the Ninth Circuit.

The plaintiff in error respectfully requests a rehearing in this case upon the following grounds:

It is well settled that in actions at law tried before the court without a jury, the special findings must support the judgment.

See authorities cited at pp. 52-53 of brief of plaintiff in error.

Neither the complaint nor the findings show that plaintiff in error had any knowledge or notice of the source from which the contractors, Rector & Daly, derived the moneys which they paid to plaintiff in error on account of the materials furnished and which were applied by plaintiff in error upon the sand and gravel account.

The decision of the court therefore must be sustained, if at all, on the broad ground that the so-called equity of the surety to have the money derived from the work under the contract applied on account of materials furnished the contractor is **absolute and wholly independent of any knowledge or notice** on the part of the person making the application of the payment.

We state advisedly that not a single authority has been or can be cited to support this rule. The Washington cases certainly do not support it. In the first case (Crane Co., v. Pac. Heat & Power Co., 36 Washington, 95), the fact of knowledge was conceded by the demurrer to the answer, which alleged knowledge. In Hughes & Co., v. Flint, 61 Wash. 460, the decision in 36 Wash. 95, was ex-

plained as having been placed upon the ground of knowledge. This is clearly shown in the dissenting opinion of his Honor, Judge Rudkin.

We now come to the latest decision on the subject in that state. It is the case of Puget Sound State Bank v. Gallucci et al, 144 Pa. 698. The following are the facts so far as the question involved in this case is concerned.

Gallucci had three separate contracts for public improvements in the city of Tacoma. He gave three bonds under the statute in question, signed by himself and a surety. The action was against Gallucci and this surety upon these three bonds. It was brought not by a materialman but by a bank. The bond was so worded that the Supreme Court held that the surety was liable, not only to materialmen **but to those who had furnished the contractor money, provided it** could be shown that the money so furnished the contractor had actually been used in payment for labor and material under the contract. In other words, the bond as construed by the Supreme Court subrogated the plaintiff bank to all of the rights of those who

did work and furnished materials under the contract to the extent that the bank could show that the money so furnished the contractor had actually gone to pay for such work and material.

The trial court found, and its finding in this respect was affirmed by the Supreme Court, that of $32,000 loaned by the bank to the contractor $18,425 could be traced as having been used to pay for such work and material. The bank therefore was in the same position with respect to the surety that plaintiff in error in this case was in with respect to the surety in this case, namely, that bank had two claims against the contractor; one for $18,425, with respect to which it held the surety bonds as security, and the other, to-wit, the balance of its claim for $32,000, a **general** claim against the contractor Gallucci, **for which it held no security.** It appeared that the trial court in fixing the liability of the surety at $18,425 found that $15,787 of this was for money loaned by the bank to Gallucci, which was applied by him in payment for labor and material used in the improvement **in district No. 1101,** to which one of the three

contracts related.

It was urged by the surety that inasmuch as it was held liable for $15,787 on account of the money which had gone to pay for work and material used in the improvement of district No. 1101, the bank should be compelled to credit on this item all moneys received by the bank on account of work done under the contract relating to district No. 1101.

There was the strongest possible ground for making this claim, because it was undisputed that the plaintiff **bank knew** that the payment of $10,863.51, which the surety company claimed should be so applied, **came directly to the bank from the city on account of the payment under the contract relating to district No. 1101.**

Here then is a case where the bank standing exactly in the shoes of the plaintiff in error in this case, held two claims against the contractor, for one of which the surety was liable, and for the other of which it was not liable, and the bank with **knowledge** that the money received came from the contract for which the surety was responsible,

deliberately applied the money in payment of the indebtedness against Gallucci for which the surety was not liable, and the Supreme Court of Washington sustained this application and has thereby practically overruled the two prior cases holding that the surety has a right to set aside the application of the payment where the creditor **knows** the source from which the money comes.

Certainly the decision in this Washington case shows that this court is wholly unjustified in saying that the Supreme Court of Washington has laid down the astonishing doctrine that the innocent creditor must have an application of payment made by him without knowledge of any equity, set aside, not because the money did not belong to the debtor, but because a surety has a so-called equity to have the money applied on another debt.

In the case last cited the court said:

> "It is contended by counsel for appellant that, in any event, the surety company is entitled to have credited upon its liability under the bonds the sum of $10,863,51, paid to the

bank upon its indebtedness. We think the answer to this is that when this sum was paid to the bank, upon Gallucci's indebtedness, the bank was not directed by Gallucci to apply it upon any particular portion of the indebtedness. It would seem plain, therefore, that the bank might apply it according to its own pleasure. **It was not required to apply it, we think, upon the portion of the indebtedness which it was entitled to make claim for against the bonds. Nor do we think the fact that this money came from the proceeds of district No. 1101 would change the bank's right in this regard.** It is practically the same as if the money or proceeds had been paid by the city to Gallucci and then by Gallucci to the bank upon his indebtedness, **although it appears that it was paid by the city to the bank upon the order or assignment of Gallucci."**

Under the doctrine laid down by this court the innocent creditor who has applied the payment upon the debt for which the surety is not liable, may at a later date, perhaps after the lapse of

several years, find that the application of the payment must be set aside, no matter what the consequence to him may be. This doctrine ignores the fact that the creditor receiving the payment has equities as well as the surety. An application by him made in good faith without knowledge of any equity certainly gives him, in addition to his legal right to stand upon the application made by him, an equity, every bit as strong as that of the surety; especially is this so, when we consider how vital it is that the business world should be allowed to accept money in payment without being compelled to inquire whence the money came.

The creditor on the assumption that he has made a lawful application of payment will in the future shape his whole conduct in a way different from what he would have shaped it if he had applied or been compelled to apply the payment on the other account. This doctrine would demoralize the business world in cases of this kind. No creditor could tell whether an honest application of a payment made by him would stand, or whether it would be set aside in the future. This rule casts upon the

creditor the unheard of duty of interrogating the contractor to find out whence came the money with which the payment is made. Such an inquiry is rightly characterized by his Honor, Judge Rudkin, as an **"impertinence at the best."** But the doctrine laid down in this case goes further and holds that the innocence of the creditor is immaterial, and that therefore it may be useless for him to make this impertinent inquiry of the contractor, for the reason that if the contractor should make a false statement as to the source of the money, he (the creditor) would be no better off than if he had not made the inquiry because of the alleged **absolute right** of the surety to have the money applied in extinction of his liability, if it came from the particular contract for which he is surety. This rule is very properly called by his Honor, Judge Rudkin, in his opinion an **inexorable rule of law.**

Let us proceed a step further. If the surety has an absolute right to have all payments which came from the contract applied in discharge of his liability upon the debt for materials furnished under

the contract, then the following result would be inevitable. If the surety, in ignorance of the fact that certain payments made by the contractor had been made by money derived from the contract, should pay under his supposed liability on the bond, a claim for materials furnished the contractor, he (the surety) could subsequently, on discovering the mistake, sue the materialman to recover back the money as money paid under a mistake of fact.

Suppose such materialman had two claims of $10,000.00 each against the contractor. One is for material furnished under the contract, the other is for material furnished the contractor for some other purpose. The contractor makes a payment of $10,000.00 and it is applied by the materialman upon the claim for which the surety is not liable in ignorance of the source from which the money came. The surety, also ignorant of the source from which the money came and believing he is liable on his bond, voluntarily pays the claim of the materialman for $10,000.00. Subsequently the surety discovers that the money with which the contractor made the payment of $10,000.00 was

derived from the contract for which the surety was liable. Under the rule laid down in this case, the surety can recover this $10,000.00 as money paid under a mistake of fact, because in the supposed case the surety would not be liable for a dollar.

The court in its opinion wholly ignored the rule of law set forth at pp. 29 to 35, both inclusive, of the brief of plaintiff in error. These rules of law are that if any party receives **money,** or what is in law the equivalent of money—a check or draft—in payment of an **antecedent debt,** but honestly believing the money to belong to his debtor, he cannot be compelled to refund the money to the true owner, although such owner can show that the money with which such payment was made was money stolen from him by the debtor, and can trace the money directly through the hands of the debtor into the pocket of the creditor.

In other words, the defendants in error could not recover from plaintiff in error the amount of these payments, even though they could show that the very money used in making these payments was

stolen from them by the contractors and paid to plaintiff in error. But this court by the doctrine laid down by it has permitted defendants in error in effect to recover the amount of these payments by setting aside a lawful application of such payments made by plaintiff in error to an antecedent debt owing it by the contractors, and giving the sureties the benefit of these payments. This is taking the money from the pocket of plaintiff in error and putting it in the pocket of the sureties after the plaintiff in error has in good faith, lawfully used this money to pay a debt owing it.

This court has therefore held that defendants in error who have a **mere equity** in this money at the most, have greater rights in following it in the hands of an innocent creditor than if they originally held the **full title** to the money and could trace it directly into the pocket of the plaintiff in error.

This rule is so extraordinary and so squarely in the teeth of the elementary rules relating to the free exchange of money as to fully justify the language of his Honor, Judge Rudkin in his dis-

senting opinion when he says:

> "**It** (the majority opinion) **places restraints on the free use and exchange of money which have not heretofore received judicial sanction. In that respect it stands unsupported and alone.**"

The decision is squarely against another line of decisions. This court is familiar with the trust fund doctrine. A party may in equity follow his property or money so long as he can trace it, although its form has been changed. But all the decisions agree that this doctrine has no application to the case of **money** which has been received by the third person in payment of an **antecedent debt,** unless he **knew** of the equitable rights of the owner.

See authorities cited at pp. 37-38 of brief of plaintiff in error.

Applying that doctrine to this case the following conclusion would result. If the moneys with which the payments were made to plaintiff in error were in equity the moneys of defendants in error (the sureties), they (the sureties) could not follow these

moneys into the hands of the plaintiff in error, without showing that plaintiff in error knew, at the time the moneys were applied by it on its claim against the contractors that the moneys were in equity the moneys of the sureties. But the sureties in this case had neither legal nor equitable title to these moneys. These moneys did not belong to them in equity or at all. At the very most they had a so-called equity in the application of these moneys to the crushed rock account instead of to the sand and gravel account. And yet the decision of this court is that these sureties, although possessing a mere equity of this kind, are in a stronger position than they would be if the moneys paid to plaintiff in error were in equity their moneys. They do not have to show any knowledge on the part of plaintiff in error.

The decision in this case runs counter also to another settled rule of law, which holds that notice is necessary. That rule is this: If a public officer with two different sets of sureties upon his official bonds for two successive terms uses money received during the second term to pay obligations arising

against him during the first term, the sureties on his second bond cannot complain of this application of payment unless the public authorities to whom the payment is made **know** that the moneys so applied were collected during the second term. This matter is fully discussed, and the authorities on this point are cited at pp. 23-27 of brief of plaintiff in error.

The distinction is there pointed out between cases of the kind referred to and those cases in which the public officer is a mere **custodian** of the money. Of course when this is the case **the relation of debtor and creditor does not exist** between such public officers and the public, and therefore when such public officer as mere custodian of the money collected during the second term and belonging to the public, pays over this money to the public, no application of this money by the public on account of collections made during the first term can be made, for the simple reason that the public officer in that case is not making, and the public is not receiving, **any payment,** but

on the contrary, the public officer is actually accounting for the money received during the second term and in his hands as mere custodian. It is obvious that in such case the knowledge of the public as to the source from which the money came is wholly immaterial. This distinction is clearly pointed out in the discussion of this question at pp. 23-27 of brief of plaintiff in error.

If these sureties have an absolute equity as against plaintiff in error to have the moneys derived from the contract applied in payment of the bills for materials furnished thereunder, then the logic of this doctrine is that plaintiff in error could have no right to apply these moneys on the sand and gravel account, even though it had no account against the contractors for materials furnished for the contract. Such a conclusion is absurd. We contend that plaintiff in error would have the right to so apply the money in such a case, even though it knew that the money had come from this contract. The money in such a case would be the money of the contractors, and

plaintiff in error would be under no obligation to assume that the contractors were insolvent, or if even insolvent, that the effect of the transaction would operate as a fraud upon the sureties. Let the sureties protect themselves by taking security received under the contract that they may be sure from the contractors, or by so controlling the funds that they are so applied as to relieve them from liability. It is not for the courts to help them by placing intolerable limitations upon the free circulation of money.

We now desire to call the court's attention to the remarkable findings of fact upon which the judgment is based. The findings necessary to sustain the judgment are these (even if we should assume that knowledge was not essential) to-wit: that Rector & Daly used moneys received by them under this contract in making payments to plaintiff in error, that such payments were in excess of the amount due for crushed rock, and that plaintiff in error applied such payments on the sand and gravel account. All the facts relating to these matters which are at all found by the

court are found in the 10th and 11th findings, and the court will search these findings in vain for any clear statement of these essential facts, pp. 25-27, Trans.

The 10th finding finds the following facts:

That an arrangement was entered into between the Vancouver bank and the contractors, under which the moneys to be derived from the contract were assigned to such bank; that in consideration thereof the bank advanced money to the contractors from time to time for carrying on the contract and for payment of labor and materials. That the money received by the bank from the contract was paid out by it to Rector & Daly and their creditors and was a sum in excess of the bill of plaintiff in error for the crushed rock. In this finding there is not the slightest hint that a dollar of this money was ever paid **to the plaintiff in error** by the contractors or by anyone else. The finding merely is that the bank paid out to the **contractors and their creditors** a sum in excess of the amount due plaintiff in error for crushed rock.

The 11th finding of facts contains the following

elements: That the bank paid to the plaintiff in error a sum in excess of the amount due it for the crushed rock, and that the money so paid to plaintiff in error was money paid by said bank against estimates for the improvement as the work progressed.

But we are not interested in the payments made by the bank, or in the question as to the claims against which such payments were made. What we are interested in finding out is whether the contractors themselves made such payments and whether in making them they used the money received from this contract. The finding then proceeds to state that the money paid plaintiff in error through said bank was realized from the work and improvement under the contract for which defendants in error were sureties.

But this is a mere conclusion, for the facts which determine whether such moneys were realized from such contract are specifically stated in these findings, and they show that the money was not so realized. And then this finding further

asserts that these moneys were the **same moneys "for the collection and payment of which the sureties were obligated."** This last finding is senseless, because the sureties were not obligated for the collection and payment of any moneys under the contract. They did not agree that the contractors would use moneys received from the contract in paying for the materials used in the performance thereof. Their obligation is an **absolute** obligation as sureties that the contractors would pay for all materials used under the contract, whether such contractors did or did not use in making such payments the moneys received by them under the contract.

We assert that these two findings will be searched in vain for any clear and coherent statement of the facts necessary to sustain the judgment on the theory on which it is sought to be sustained. They show on their face merely this state of facts: That the contractors assigned the moneys due under the contract to the bank as collateral for moneys to be advanced; that such moneys were advanced

from time to time, and that the bank and not the contractors made the payments to the plaintiff in error. This latter version of the transaction is wholly unsustained by the evidence. As a matter of fact, the bank never paid plaintiff in error a dollar. The sole connection of the bank with these transactions was that it took an assignment of the moneys due under the contract as collateral and loaned the contractors money from time to time, on their notes, and gave them credit for such notes in their general checking account, and that the payments that were made, were made by the contractors with their checks drawn upon their own moneys so on deposit with the bank.

Plaintiff in error challenged in the court below the 11th finding of fact, which contains everything that can possibly be urged to support the judgment. pp. 199-204, Trans.

Plaintiff in error also by specific requests, asked the court to find specifically certain facts regarding these payments which all rest on undisputed evidence. Trans., pp. 184-197.

The court in its opinion has **wholly ignored the contention of plaintiff in error regarding the real facts of the case and has accepted the findings as final.** That plaintiff in error is in position to urge the point that the evidence does not sustain the findings, and that the findings requested should have been made; see pp. 54-55 of brief of plaintiff of error.

It is impossible to discuss the facts anew in this petition. This has been done at pp. 43-50 of brief of plaintiff in error. However, we call the court's attention to the following salient points as established conclusively by the evidence.

Not a dollar of the money received by the contractors from the city ever reached the pocket of plaintiff in error. The city paid the contractors under the contract up to the time they abandoned it, only two payments. One was a cash payment by a draft of $10,046.17. The other was by the issue of bonds aggregating $11,500.00. There is not a shred of evidence tracing any of this money or the proceeds of these bonds into the pocket of

plaintiff in error. The money from the draft was drawn out the very day it was deposited. All these moneys were deposited in the general checking account of the contractors. Funds from all sorts of sources were deposited in this account, and checks to pay all kinds of bills were drawn upon it. So far as the record shows, every dollar of the money received from the draft has gone to pay other claims. The bonds were sold and the proceeds used to pay **some** of the notes of the contractors, but there **were sixteen** of such notes, aggregating over $25,000.00, and the only notes that have any bearing in tracing the moneys are **six** notes; p. 45 of brief of plaintiff in error. How do we know that a dollar of the proceeds of these bonds ever went to pay any of these six notes.

What happened was this: The contractors from time to time discounted their notes at the bank and got credit. for the proceeds. These proceeds went into their general checking account. From time to time they made payments to plaintiff in error by checks. The only possible excuse for saying that the money has been traced is that the

contractors had assigned the contract to the bank as security. This is all that the cashier claims in his evidence. He says: **"The security of these notes I have testified about was the assignment that was put on record in the clerk's office and that is the only way I know."** Trans., p. 119. In determining whether money received by plaintiff in error upon one of these checks was money derived by the contractors from the city under the contract, it is only necessary to make this practical test. Suppose after raising a particular amount of money by a particular note, the proceeds of that note being at once checked out and traced to the pocket of plaintiff in error, the contractors had, when the note fell due, paid it by money received from **another source**, would it be seriously urged that the moneys used in making this payment had been derived from the contract merely because the contract had been put up as collateral security? The attempt to trace this money falls down at a number of points.

As to the draft for $10,046.17 it appears that this was more than checked out at the very day

it was deposited. Trans., pp. 157-158.

With respect to the $11,500.00 bonds, it appears that they were sold after the loans had been made to the contractors by the bank, so that not a dollar of this money is represented by the credits given to the contractors by the bank and discounting these notes. And to cap the climax, there is no such clear evidence as the courts require in cases of this kind to show that any of the proceeds of these bonds were subsequently used to pay the notes which created the credits which it is claimed were checked against in making the payments to plaintiff in error. And what makes the contention in this behalf more untenable is the fact that the evidence to show that the checks with which these payments were made were paid out of the proceeds of certain notes, is when carefully analyzed found to be without any value in establishing this point. See pp. 46-49 of brief of plaintiff in error.

Counsel for plaintiff in error have expended a large amount of time and money in laying the foundation for the review in this court of the findings of the trial court. They not only objected to

and challenged the findings of the trial court so far as they relate to these questions, but they also requested the court to make many findings of fact relating to these payments, and they contend that all of these requests were fully justified by the evidence. We therefore respectfully insist that we have the right to have the evidence reviewed and not have the case disposed of on findings which do not represent the true facts at all.

In conclusion, we call the court's attention to the fact that the opinion wholly ignores the question of knowledge or notice. The court does not decide whether it is necessary or unnecessary, although the inevitable consequence of the decision is that knowledge is wholly immaterial.

We again direct the court's attention to the fact that the very foundation of defendants' defense is that the plaintiff in error had in fact applied these payments on the sand and gravel account, and that this application should be set aside and the moneys applied in exoneration of the sureties. The case is not a case in which the court is called upon to make application of payments which have

not been made by the parties themselves. It is a case in which a court of law is asked to set aside an application of payments honestly and innocently made, upon the ground of a mere equity without any appeal to a court of equity for such purpose.

Respectfully submitted.

R. R. GILTNER,
RUSSELL E. SEWALL,
GUY C. H. CORLISS,

Attorneys for Plaintiff in Error and Petitioner.

CERTIFICATE OF COUNSEL.

I hereby certify that I am of counsel for plaintiff in error and petitioner in the above entitled cause and that in my judgment the foregoing petition for a rehearing prepared by me is well founded in point of law as well as in fact, and that said petition is not interposed for delay.

GUY C. H. CORLISS,

Of Counsel for Plaintiff in Error and Petitioner.